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Gary S. Marx

AN ANALYSIS OF *PRESBYTERIAN & REFORMED PUBLISHING COMPANY v. COMMISSIONER*

GARY S. MARX*

In the case of *Presbyterian & Reformed Publishing Company v. Commissioner* [hereinafter *P&R*],[1] the Third Circuit held that a religious publishing company qualified as an exempt organization pursuant to section 501(c)(3) of the Internal Revenue Code. The issue in *P&R* was whether a profitable taxpayer had a nonsubstantial "commercial purpose" precluding it from exempt status. The Tax Court held that P&R was nonexempt.[2] It relied exclusively upon the objective indicia of a commercial enterprise manifested by the taxpayer. The Third Circuit reversed by applying what purported to be a more subjective analysis.[3]

This paper discusses the test for obtaining section 501(c)(3) status for a non-profit corporation whose primary activity is the operating of a trade or business to further an exempt purpose. Part one sets forth the relevant facts in the *P&R* case. Part two analyzes the *P&R* Tax Court opinion. Part three discusses the Third Circuit's standard. Part four proposes a new test for determining the availability of section 501(c)(3).

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* Of Counsel, Asbill Porter Churchill & Nellis, Washington, D.C.; A.B., Washington University, 1975; J.D. Washington & Lee School of Law, 1979; LL.M., Georgetown University Law Center, 1985.

[1] 743 F.2d 148 (3d Cir. 1984).

[2] 79 T.C. 1070 (1982), *rev'd*, 743 F.2d 148 (3d Cir. 1984).

[3] *See infra* notes 95-97.

I.

FACTS OF THE PRESBYTERIAN & REFORM PUBLISHING CASE

A. *Historical Background*

P&R was incorporated in 1931 to disseminate the "system of belief and practice" of the Orthodox Presbyterian Church (OPC).[4] In 1939 the IRS granted P&R tax-exempt status. The IRS stated: "[Y]our actual activities consist of publishing a religious paper. . .devoted to stating, defending and furthering the gospel. Your income is derived from subscriptions, contributions and gifts and is used to defray maintenance and general operating expenses."[5] Over time, *P&R* dramatically changed its activities from publishing a newspaper to publishing numerous commercially successful books.

P&R had always been predominantly a family-run concern, with its presidency passing in 1953 from Samuel Craig to his son, Charles H. Craig. Since 1976, Charles Craig's son, Bryce, had also been a full-time employee and officer of P&R. Although Bryce had a theological degree, Charles did not.[6]

P&R was not formally affiliated with any organized church. That is, P&R was not under any legal obligation to follow the directions of any church or to provide any profits to any church. However, from the beginning, P&R had been closely linked with the OPC. For example, its books express the views of that church and among the twelve most recent members of P&R's Board of Directors, nearly all had a leadership role in the OPC.[7] The OPC's seminary, the Westminster Theological Seminary of Philadelphia, is to be the recipient of all P&R's assets in case of dissolution.[8]

B. *Compensation of Employees*

Neither Samuel nor Charles Craig ever received any compensation from P&R. In addition, P&R received volunteer help in manuscript reading and editing, packing and shipping books, and clerical duties from various individuals since its inception. However, when Bryce began working at P&R in 1976, he was compensated. Bryce received salaries from 1976

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[4] 79 T.C. at 1072.
[5] *Id.* at 1073.
[6] *Id.*
[7] *Id.* at 1074. "Among [twelve] more recent members of the board of directors of P&R, nearly all had some overt religious affiliation: [four] were, or had been, church pastors, and [four] were in some way connected with" the Westminster Theological Seminary, an institution espousing the "reform" doctrine of the OPC. *Id.*
[8] 743 F.2d at 151.

to 1979, inclusive, of $12,000, 13,250, 15,000, and 15,350. While salaries to other employees had been *de minimis* during the late 60's and early 70's, they had risen to almost $60,000 by 1979.[9]

Although P&R began in the late 1970's to enter into more formal arrangements, its relationship with its authors was generally quite informal. Somewhat less than half of P&R's authors received royalties. While as little as $350.00 in royalty payments were made in 1969, by 1979 royalty payments reached $82,127.00.

C. *Decision to Publish a Particular Book*

The main criterion P&R uses to decide on a manuscript's publication is whether the book would make a "worthy contribution . . . to the reform community." P&R will publish a book which meets its theoretical standard even if it will not sell many copies. However, if a book will not sell at all, P&R will reject it. P&R has published and reprinted at least a few books rejected by other companies because they were too rigid doctrinarily or uneconomical. The books of one of P&R's authors, Jay Adams, consistently sold well.[10]

D. *Pricing*

P&R sets its prices in order to make a profit. Even when P&R sold at its greatest discount (60% off list), it did not plan to lose money. Generally, however, its profit margin was less than that of other publishers.[11] At least as early as 1975, P&R donated books to individuals who requested

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[9] 79 T.C. at 1075. The annual amounts paid as salaries (rounded for convenience) are as follows:

Year	*Amount Paid*	
1969	0	
1970	0	
1971	300.00	
1972	549.00	
1973	2,285.00	
1974	3,409.00	
1975	6,988.00	(includes commissions)
1976	$16,197.00	
1977	$23,954.00	
1978	$35,230.00	
1979	$57,597.00	

Id.

[10] *Id.* at 1078.

[11] *Id.* at 1079. There actually was not much evidence of a comparison between P&R's profit margin and that with commercial publishers. That evidence which was introduced in the Tax Court showed that while some publishers set a cost ratio of eight (cost ratio equals list price divided by unit price), P&R's cost ratio was approximately four. *Id.*

them.

E. *Accumulation of Profits*

P&R's publishing operations were initially run out of Samuel Craig's house and later out of Charles Craig's house. In 1969, the operation was moved to a garage purchased by Charles Craig and his wife.[12] As early as March 2, 1974, however, P&R informed the IRS that it was accumulating a surplus for a "building fund" and that it planned to purchase or build an office and warehouse. This statement was reasserted in nearly all future correspondence with the IRS for the years 1975 through 1977. By 1978, P&R had purchased land and constructed a building at a total cost of $262,914.00. There was also approximately $30,000.00 for equipment to be used in the publishing operation.

Payment for the new building and improvements were all made out of the petitioner's retained earnings. Prior to 1969, P&R had made no profits. In fact, Samuel and Charles Craig sometimes were required to make donations to P&R just to cover expenses. However, P&R's profits greatly expanded from 1969 through 1979 with net profits from book sales reaching approximately $105,000 for both 1975 and 1976.[13] In addition to these net profits, the taxpayer received some interest income and contributions.[14]

II.

ANALYSIS OF TAX COURT RULING.

A. *Treatment of the Fact that P&R'S Primary Activity was a Trade or Business*

The first issue which the Tax Court faced was the significance of the fact that P&R's primary activity was the operation of a trade or business. On this issue, the Tax Court ruled that "the purpose toward which an organization's activities are directed, and not the nature of the activities themselves, is ultimately dispositive of the organization's right to be classified as a [section] 501(c)(3) organization."[15] The Tax Court relied on its prior holding in *B.S.W. Group Inc. v. Commissioner*,[16] in which it held:

> The fact that petitioner's activity may constitute a trade or business does

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[12] *Id.* at 1075. Charles Craig received rent from P&R sufficient to cover real estate taxes he personally paid while leaving a modest excess for other expenses. *Id.* at 1076.

[13] *Id.* at 1077.

[14] *Id.* at 1078. The contributions were for the most part nominal. For the years 1973 through 1978, the taxpayer received no contributions. *Id.* The highest amount of contributions was $11,785.00 in 1969, the year in which net profit on sales was only $3,000. *Id.*

[15] 79 T.C. at 1082, citing B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352, 356-357 (1978).

[16] 70 T.C. 352 (1978).

> not, of itself, disqualify it from classification under section 501(c)(3), provided the activity furthers or accomplishes an exempt purpose [citations omitted]. Rather, the critical inquiry is whether the petitioner's primary purpose for engaging in its sole activity is an exempt purpose, or whether its primary purpose is the nonexempt one of operating a commercial business producing net profits for petitioner.[17]

In *B.S.W.*, the Tax Court had found nonexempt a taxpayer which was formed for the purpose of providing consulting services primarily in the area of rural-related policy and program development where those services were sold above cost and were in competition with for-profit organizations.

1. *Whether the Fact That P&R's Sole Activity Was Carrying on Trade or Business Should Have Precluded an Exemption*

The first question raised by the Tax Court's opinion is whether the "nature" of P&R's activity should have been considered. Arguably, section 502 of the Internal Revenue Code precludes the granting of exempt status to an organization whose sole activity is the operating of a trade business.

Section 502 provides: "[A]n organization operated for the primary purpose of carrying on a trade or business for profit shall not be exempt from taxation under § 501 on the ground that all of its profits are payable to one or more organizations exempt from taxation under § 501 from taxation." The section was designed to overrule a line of cases holding that where a corporation operates a trade or business solely for the purpose of providing income to an exempt organization, the organization operating the trade or business itself qualifies for exemption.[18] Essentially, these cases held that since the ultimate purpose of the trade or business was charitable, the operation of the trade or business did not preclude exempt status.[19] For example, in the pre-section 502 case of *Roche's Beach, Inc. v. Commissioner*,[20] the Second Circuit court found exempt an organization

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[17] *Id.* at 357. The *B.S.W.* court cited IRS Regulations § 1.501(c)(3)-1(c)(1) and 1.501(c)(3)-1(e)(1) and two court opinions, *San Francisco Infant School, Inc. v. Commissioner*, 69 T.C. 957 (1978), involving a daycare center, and *Monterey Public Parking Corp. v. United States*, 481 F.2d 175 (9th Cir. 1973), involving a downtown parking lot developed as part of urban renewal. In both court cases, it was established that the taxpayer was not in competition with a for-profit concern. Arguably, such cases do not support the Tax Court's proposition that an exempt organization's sole activity can be a trade or business when the organization competes with commercial enterprises.

[18] *See* H.R. REP. No. 2319, 81st Cong., 2nd Sess. 36, 41 (1950); S. REP. No. 2375, 81st Cong., 2nd Sess. 28, 35 (1950).

[19] Southeastern Fair Ass'n v. United States, 52 F. Supp. 219 (Ct. Cl. 1943). Sand Springs Home v. Commissioner, 6 B.T.A. 198 (1927).

[20] 96 F.2d 776 (2d Cir. 1938).

which owned a public bathing beach and operated related concession stands. All the profits of the organization were turned over to a charitable foundation. The court reasoned that "[t]he destination of the income is more significant than its source," and therefore the taxpayer's operation of the trade or business did not preclude exemption.[21] Similarly, in *C.F. Mueller v. Commissioner*,[22] a macaroni factory which turned all its profits over to New York University was found exempt.[23] Congress' rejection of such cases arguably indicates that if an organization's sole activity is the operation of a trade or business, the purpose for which the trade or business is operated is irrelevant. Under this rationale, section 501(c)(3) is available to any organization which is "operated for the primary purpose of carrying on a trade or business."

The legislative history of section 502, however, indicates that such an argument overstates Congress' intent. First, section 502 is limited to those instances where a corporation claims exemption on the basis of another corporation's exemption. The statutory language implies that if the organization claims exemption on any other grounds, section 502 is not applicable. For example, if the organization concerned claimed exemption because of its own activities, rather than those of an organization to whom its profits are payable, section 502 cannot be invoked.

Second, section 502 was enacted along with section 511, which provides for the taxation of the unrelated business income of an otherwise exempt organization. Under section 511, where an exempt organization carries on a trade or business furthering an exempt purpose, the unrelated business income tax provisions are inapplicable. This indicates that there is no limit on the amount of related business income which a corporation can obtain.[24]

Third, the cases cited in the legislative history to section 502 all concern those instances where a "feeder" corporation carried on a trade or business unrelated to the exempt purpose. For example, in discussing section 502, on the floor of Congress, Senator George, of Georgia, said:

> The House bill subjected to tax the income of so-called "feeder" organizations. These are organizations whose only activities are the operation of a business who turn over the income earned to taxes and to organizations.

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[21] *Id.* at 778.

[22] 190 F.2d 120 (3d Cir. 1951).

[23] *Id. See also,* Lichter Foundation, Inc. v. Welch, 247 F.2d 431 (6th Cir. 1957); Boman v. Commissioner, 240 F.2d 767 (8th Cir. 1957); Willingham v. Home Oil Mill, 181 F.2d 9 (5th Cir.), *cert. denied,* 340 U.S. 852 (1950).

[24] The background of the unrelated business income provisions (§§ 511-513) indicate that they are based upon a desire to pacify competitors of exempt organizations (*e.g.*, for-profit macaroni factories) rather than to restrict a charity's exempt activities. *See* K. Eliasberg, *Charity and Commerce, § 501(c)(3) — How Much Unrelated Business Activity?* 21 TAX L. REV. 53 (1965).

> The highly publicized Mueller macaroni factory is in point. Your Committee has accepted this provision of the House Bill without change.[25]

Similarly, the only cases cited in the Senate Report were those involving trade or businesses unrelated to the exempt purpose:

> In the area covered by this amendment, there has been litigation as to the application of such a rule under existing law (*c.f. Roche's Beach, Inc. v. Commissioner*, C.C.A. 2, 1938), 96 F.2d 776; *Universal Oil Products Company v. Campbell* (C.A. 7, 1950), 181 F.2d 451; *Willingham v. Home Oil Mill* (C.A. 5, 1950), 181 F.2d 9; *C.F. Mueller Co.*, 14 T.C. No. 111½ (May 25, 1950). The amendment is intended to show clearly what, from its effective date, the rule is to be, without disturbing the determination in present litigation with the rule under existing law.[26]

Accordingly, while Section 502 does not characterize the type of business it prohibits, *i.e.*, related or unrelated, the legislative history indicates that it did not intend to tax income from related business activity.[27] Thus, if a taxpayer whose primary activity is the operation of trade or business can prove that its trade or business furthers an exempt purpose, § 502 does not preclude exempt status.

2. *Examples of Trade or Business*

The most extreme example of the Tax Court's acceptance of an organization's operation of a trade or business occurred in *Edward Orton, Jr. Ceramic Foundation v. Commissioner.*[28] In *Orton*, a foundation took over and operated a testator's pyrometric cone manufacturing business and applied the profits therefrom to research in the field of ceramic engineering. The cones were priced to bring a profit of 20%. The profits were used to further research in pyrometrics. The Tax Court found the taxpayer exempt even though the company was in direct competition with other cone manufacturers.[29] Similarly, in *Monterey Public Parking Corp.*

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[25] 96 Cong. Rec. 13274 (1950).

[26] S. REP. No. 2375, 81st Cong., 2nd Sess. 116 (1950).

[27] Eliasberg, *supra* note 24, at 83.

[28] 56 T.C. 147 (1971).

[29] The dissent in *Orton* would have accepted the § 502 analysis as precluding exemption:

> By imposing the tax on *unrelated*-business income of an otherwise bona fide exempt charitable organization, Congress attempted to avoid taxing business income derived from an exempt organization's activities which were necessarily an integrally part of the organization's exempt functions. Thus, the regulations, which follow the intent of Congress as reflected in the reports of congressional committees, make explicit that the sort of activity which is intended to escape the tax is (1) a relatively small-scale enterprise (in comparison with the organization's charitable activities), (2) which is integrally related to the performance of the organization's exempt functions, and (3) which has as its primary purpose the advancement of such exempt functions.

Orton, 56 T.C. at 170 (Raum, J., dissenting).

v. Commissioner,[30] an exemption was granted to an organization whose sole activity was the operation of a downtown parking lot. And in *San Francisco Infant School, Inc. v. Commissioner*,[31] an exception was granted to a taxpayer whose sole activity was the operation of a day care center. These cases indicate that under appropriate circumstances businesses which otherwise appear purely commercial may qualify for exemption.

B. *Treatment of Multiple Purposes*

The *P&R* Tax Court recognized that where an organization engages in only one activity (*i.e.*, a trade or business) that activity may further multiple purposes, exempt and nonexempt. Under the literal language of section 501(c)(3), the corporation is entitled to an exemption only if it is "exclusively" for exempt purposes. Under this test, any nonexempt purpose would preclude the exemption. However, it has generally been recognized that the term "exclusively" should not be construed to mean "solely" or "absolutely without exception."[32] Thus, the *P&R* Tax Court holds that the presence of any substantial nonexempt purpose bars applicability of section 501(c)(3). The Tax Court relied upon language from the Supreme Court's decision in *Better Business Bureau v. United States* to the effect that "[T]he presence of a single [nonexempt] . . . purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [exempt] . . . purposes."[33] While *Better Business Bureau* dealt with Social Security taxes, the statutory language in that case is comparable to the critical language of section 501. In adopting the *Better Business Bureau* test, the *P&R* court followed a substantial line of case authority.[34]

In adopting this test, however, the *P&R* Tax Court rejected other authority which phrased the standard in terms of whether an organization's *primary purpose* is exempt or nonexempt. The cases articulating this approach tend to be ones in which an exemption is upheld. For ex-

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[30] 481 F.2d 175 (9th Cir. 1973).

[31] 69 T.C. 957 (1978).

[32] *See, e.g.*, Church v. Commissioner, 71 T.C. 102, 107 (1978); Industrial Aid for the Blind v. Commissioner, 73 T.C. 96 (1979); Peoples Translation Service v. Commissioner, 72 T.C. 42 (1979); I.R.C. § 1.501(c)(3)-1(e)(1)(1954)(Income Tax Regulations).

[33] 326 U.S. 279, 283 (1945).

[34] Copyright Clearance Center, Inc. v. Commissioner, 79 T.C. 793 (1982); Syrang Aero Club, Inc. v. Commissioner, 73 T.C. 717, 722-23 (1980); Christian Manner Int'l, Inc. v. Commissioner, 71 T.C. 661, 668 (1979); Christian Stewardship Assistance v. Commissioner, 70 T.C. 1037, 1040 (1978); Fides Publishers Ass'n v. United States, 263 F. Supp. 924, 935 (N.D. Ind. 1967); *c.f.* Est of Hawaii v. Commissioner, 71 T.C. 1067, 1079 (1979), *aff'd*, 647 F.2d 170 (9th Cir. 1981).

ample, in *Industrial Aid to the Blind v. Commissioner*,[35] the Tax Court held exempt an organization organized to purchase and sell products manufactured at the Wisconsin Workshop For The Blind, reasoning that "[a]ssuming arguendo that petitioner had a dual purpose, to alleviate the problems of visually handicapped individuals and to engage in the business for a profit, the former purpose is primary."[36] Similarly, in *Pulpit Resource v. Commissioner*,[37] the Tax Court held exempt an organization whose function was the printing of sermons which could be used by ministers, priests, rabbis etc., by reasoning that "the critical inquiry is whether the primary purpose for engaging in the sole activity is the exempt purpose or the nonexempt purpose; whether the nonexempt purpose was primary or merely incidental to the exempt purpose."[38] In fact, the Tax Court has held that a substantial nonexempt activity which is an integral and inseparable part of an exempt activity does not result in the denial of the tax exemption.[39] There are quite a few decisions in which taxpayers clearly had more than a *de minimis* nonexempt purpose but the exemption was allowed.[40]

The liberal construction which the tax exemption provisions are generally entitled support the "primary" test rejected by the *P&R* court.[41] In addition, a strong argument can be made that the *Better Business Bureau* test relied upon by the *P&R* court was limited to those instances where the commercial purpose was clear from the taxpayer's organizational documents (as was the case in *Better Business Bureau*).[42] However, two lines of argument support the Tax Court's decision. First, Congress' choice of the word "exclusively" in section 501(c)(3) by necessity places some limits on construction. Second, unless courts are willing to distinguish *Better Business Bureau* on the facts, they would appear to be bound by the Supreme Court's use of the "substantial in nature" test

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[35] 73 T.C. 96 (1979).

[36] *Id.* at 102 n.2.

[37] 70 T.C. 594 (1978).

[38] *Id.* at 610. *See also* American Institute for Economic Research v. United States, 302 F.2d 394, 398 (1962); Scripture Press Found. v. United States, 152 Ct. Cl. 463, 469 (1961); Elisien Guild, Inc. v. United States, 412 F.2d 121, 124 (1st Cir. 1969); B.S.W. Group, Inc. Purchasing Center, Inc. v. Commissioner, 70 T.C. 352 (1978).

[39] *See* San Francisco Infant School v. Commissioner, 69 T.C. 957, 965-966 (1978).

[40] *See e.g.*, St. Louis Union Trust Co. v. United States, 374 F.2d 427, 431 (8th Cir. 1967); Dulles v. Johnson, 273 F.2d 362, 368 (2nd Cir. 1959), *cert. denied*, 364 U.S. 834 (1960); Seasongood v. Commissioner, 227 F.2d 907, 910 (6th Cir. 1955); Kentucky Bar Found. v. Commissioner, 78 T.C. 921, 923 (1982); *Greater United Navajo Dev. Enters. v. Commissioner*, 74 T.C. 69, 77-78 (1980), *aff'd* 672 F.2d 922 (9th Cir 1981): Church v. Commissioner, 71 T.C. 102; 107 (1978).

[41] *See, e.g.*, Passaic United Hebrew Burial Ass'n. v. United States, 216 F. Supp. 500, 505 (D.N.J. 1963).

[42] *See* note 97, *infra*.

even if public policy would support a more liberal standard. Accordingly, the *P&R* Tax Court's holding with regard to the standard to be applied appears reasonable.[43]

C. *The Tax Court's Test For Determining the Taxpayer's "Purpose"*

After determining that the issue in cases such as *P&R* is whether the taxpayer has substantial commercial "purpose," the Tax Court turned to the issue of how to determine the taxpayer's true intent. The Tax Court reasoned that the "purpose" is to be derived from a review of the objective facts relating to the organization's operation. The *P&R* Tax Court held:

> Where a nonexempt purpose is not an expressed goal, courts have focused on the manner in which activities themselves are carried on, implicitly reasoning that an end can be inferred from the chosen means. If, for example, an organization's management decisions replicate those of commercial enterprises, it is a fair inference that at least one purpose is commercial, and hence nonexempt. [I]f this nonexempt goal is substantial, tax-exempt status must be denied.[44]

Thus, the Tax Court establishes a rule that if an organization operates as a commercial business it must necessarily have a commercial purpose. Having decided that the corporation's "purpose" is to be determined on the basis of objective facts, the issue is what facts are relevant.

1. *The Presence of Substantial Profits*

The *P&R* Tax Court held that "among the factors indicating nonexempt purpose is the presence of substantial profits." As the court notes, of equal importance is the related factor of a method of pricing the organization's product (*i.e.*, of the religious publications).

The court reasoned that "we consider it very significant that, generally speaking, petitioner established prices which not only bring in sizeable profits, but which did so at consistent and comfortable net profit margins."[45] The Tax Court was particularly critical of P&R for not lowering the price of the books of its popular authors in order to increase the fulfillment of the organization's exempt purpose of disseminating its religious beliefs. It further noted that during the period of expansion (1969-1979) profits peaked at over $105,000 and averaged in the later years approximately $60,000.[46]

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[43] *Accord*, Copyright Clearance Center v. Commissioner, 79 T.C. 789 (1982).

[44] 79 T.C. at 82-83.

[45] *Id.* at 1085.

[46] 71 T.C. 202 (1978). The *Aid to Artisans* court held:

> We are required first to focus on the organization's primary activities and determine

The Tax Court's focus on profits is consistent with prior precedent. However, the mere presence of profit is not determinative where the taxpayer can show that the profits are being used for an exempt purpose. For example, in *Aid to Artisans, Inc. v. Commissioner*,[47] the Tax Court upheld an exemption to a corporation organized to promote the handicraft output of disadvantaged artisans in developing societies of the world. The *Aid to Artisan* Court noted that while the taxpayer's products were sold to make profits, the profits were spent in furthering the corporation's exempt purpose. Thus, according to the court, there was no "commercial purpose."

Similarly, in *Edward Orton, Jr., Ceramic Foundation v. Commissioner*,[48] the corporation intentionally priced its product to make a twenty percent profit. While the profits were substantial, they were all required to be spent on research furthering the corporation's scientific purpose. Again, the court found no "commercial purpose."

If an organization can show that the profits are necessary to cover its own expenses, including reasonable salaries, the presence of profits will not be determinative. This will be the case especially if the taxpayer shows that it is unable to obtain income from other sources.[49] For example, the taxpayer in *Pulpit Resource v. Commissioner*,[50] was a corporation which printed sermons which could be used by people such as ministers, priests, and rabbis. The corporation's objective was to disseminate sermons to ministers to improve their religious preachings. In upholding the

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> whether they accomplish one or more exempt purposes. Then we must determine whether a substantial or insubstantial part of the organization's activities further nonexempt purposes. If one or more exempt purposes are accomplished by the organization's primary activities and if an insubstantial part of the organization's activities are devoted to the accomplishment of non-exempt purposes, then the organization is operated exclusively for exempt purposes. Note that the presence of profitmaking activities is not a per se bar to qualification of an organization as exempt if the activities further or accomplish an exempt purpose.

Id. at 211.

[47] 71 T.C. 202 (1978).

[48] 56 T.C. 147 (1971). The *Orton* case distinguished other cases in which large profits were found indicative of a non-exempt purpose by stating:

> Fundamental to determinations in those cases that the organizations in question were not exempt were findings of large profits, substantial accumulations of income, and relatively small amounts of actual exempt activity. Petitioner, on the other hand, was not a business of burgeoning profits, and greatly increasing accumulations of income in relation to distributions.

Id. at 159.

[49] Of course, if an organization which portends as being charitable is unable to attract donations and there is substantial accumulation of large profits, you could assume that if the activity performed by the exempt organization were truly charitable, there would be members of the public interested in supporting the entity.

[50] 70 T.C. 594 (1978).

exemption, the Tax Court held that the fact that "[the] petitioner intended to make a profit, alone, does not negate that petitioner was operated exclusively for charitable purposes."[51] According to the court, "[a]pparently the only way petitioner could accomplish its objective of disseminating sermons to ministers to improve their religious preachings was by selling Pulpit Resource at a price sufficient to pay for its cost and provide [its officers] with a reasonable salary."[52]

Cases such as *Aid to Artisans, Orton*, and *Pulpit Resource*, raise the question of whether it is appropriate to look at how the profits are used in determining whether an exemption is appropriate. Arguably, Congress' rejection of the "destination of income test" in section 502 and its enactment in 1950 of the unrelated business income provisions indicates that courts should not look at how profits are spent in determining exemption from taxation.[53]

While such an argument raises a close question, the Tax Court's rejection of this position appears appropriate. Congress' concern with the unrelated business income, as with section 502, was to correct what appeared to be the unfair competitive advantage given to non-profit corporations when competing with for-profit corporations.[54] Congress' refusal to tax income from related trade or business indicated that Congress did not intend to stifle such activity. In cases such as *Aid to Artisans, Orton* and *Pulpit Resource*, the courts found that the income was from a "related trade or business." Once that finding is made, the only inquiry should be whether the taxpayer's officers had a non-substantial commercial purpose. On that narrow issue, it would appear that the corporation's use of the income is a relevant factor. Accordingly, Congress' rejection of the destination of income test for purposes of section 502 and for unrelated trade or businesses would not be an appropriate basis for precluding a review of how an exempt organization's profits from a related trade or business are used.

2. *Accumulation of Profits*

P&R argued that its accumulation of profits was for the purpose of expanding its operations and thereby augmenting the dissemination of its beliefs. Cash on hand reached $417,844 in 1976 before being reduced by the cost of building its new plant to $208,200 in 1978, and then to

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[51] *Id.* at 611.

[52] *Id.* The Tax Court appeared willing to accept the presence of a small profit only because the taxpayer was able to show that no commercial enterprise would have performed the activity which the Tax Court had found to fulfill a religious objective.

[53] *See* I.R.C. § 511-513 on related business income. As to the history of these provisions, *see* Eliasberg, *supra* note 24, at 78-81.

[54] *See* Elisberg, *supra* note 24, at 78-81.

$111,826 in 1979.[55] Apparently, because of the size of the accumulation and the expansion, the Tax Court rejected P&R's argument that the accumulation furthered a charitable purpose. The court stated: "[s]uch increase, however, may also be indicative of a commercial enterprise. We are not convinced that one of the significant reasons for expansion was not the commercial one of wishing to expand production for profit."[56]

No other case has penalized a taxpayer where the taxpayer proffered a legitimate reason for the accumulation. Probably the most significant case in which accumulated capital played a role is *Scripture Press Foundation v. United States*.[57] The taxpayer in that case "vigorously argue[d] that its primary interest was to better the Sunday schools of America by improving both the quality of instruction and the materials used in those schools. The instructional aspect of this endeavor involved outlays of monies by the plaintiff."[58] The Court of Appeals reasoned that "it is fair in making a determination as to what was the most important aspect of plaintiff's work to compare how much plaintiff accumulated as a result of its sales of religious literature and how much it expended for instructional activities."[59] The court found that during the latter years in question the accumulated capital and surplus exceeded 1.5 million dollars, while expenditures for religious programs were less than $100,000.[60] The court concluded that "the enormity of the contrast between what plaintiff has accumulated from sales each year and what it has expended for its educational programs reveals that the sale of religious literature is its primary activity and that its instructional phase is incidental thereto."[61] The court noted that even though the taxpayer had built a new building costing in excess of one million dollars, that "[e]ven allowing for the cost of the building, however, the disparity between amounts actually expended for instruction when compared with amounts realized in earnings is unaccountably small."[62]

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[55] *See* 79 T.C. 1070 (1982).

[56] *Id.* at 1086.

[57] 285 F.2d 800 (Ct. Cl. 1961), *cert. denied*, 368 U.S. 985 (1962).

[58] 285 F.2d at 804. The *Scripture Press* court stated that the test to be used was whether the sale of religious literature by the plaintiffs in this case was incidental to the plaintiff's religious purposes or incidental to the sale of religious literature. *Id.* at 803-04.

[59] *Id.* at 804.

[60] *See id.* at 804-05.

[61] *Id.*

[62] *Id.* at 805.

The *Scripture Press* court apparently rejected the subjective test adopted by the Third Circuit in the *P&R* case. The court held:

> The evidence in this case, as is amply borne out by the findings of the trial commissioner, shows that throughout its history Scripture Press has been led by people of devout and intense religious conviction. However, the intensity of the religious convictions of the plaintiff's members and officers cannot operate to exempt them from

A second major case focusing on the accumulation of profits is *Incorporated Trustees of the Gospel Worker Society v. United States Department of Treasury*.[63] The organization in *Gospel Workers* sold Sunday School literature and used the money received to operate a home for elderly women who were part of the society. The taxpayer competed with a few other non-profit corporations. The material was sold at a profit.[64] Gospel Worker's accumulated surplus grew from approximately two million dollars through the 1960's to over 5.3 million dollars in 1978. In finding there was no exempt purpose for the accumulation, the district court held:

> While it is theoretically conceivable that a religious purpose may underlie the enormous accumulation of profits since 1970, the sheer size of the surplus and the lack of anything more concrete than the word of plaintiff's officers as to its future use militates against such a finding. Even if it be assumed, *arguendo*, that the funds now accumulated will eventually be used for expansion, it would not help plaintiff's case, for the purpose of the expansion may well be the accumulation of still greater profits. Plaintiff has given the Court no basis to find otherwise.[65]

The *Gospel Worker* court was clearly troubled by the failure of the taxpayer to introduce proof of why it was accumulating the surplus. The court stated that:

> The burden of proof to overcome the grounds set forth by the IRS in its revocation lies with the plaintiff [footnote omitted] — that is, plaintiff may overcome the IRS finding that the operation of the Gospel Press is not substantially related to the performance of an exempt function. Plaintiff has not sufficiently established a connection between the accumulation of profits and some religious purpose so as to overcome that finding.[66]

One obvious distinction between cases such as *Scripture Press* and

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> the tax law if the activities of the plaintiff cannot in themselves justify such an exemption. Piety is no defense to the assessments of the tax collector.

Id. at 804. Thus, the *Scripture Press* court seems to be saying that even a religious purpose will not justify an exemption if the objective facts indicate a possible commercial purpose. The *Scripture Press* holding on this point appears particularly wrong since the ultimate issue here is the taxpayer's motive — a question of the taxpayer's intent assuming charitable purpose is fulfilled.

[63] 510 F. Supp. 374 (D.D.C. 1981), *aff'd mem.*, 672 F.2d 894 (App. D.C. 1981), *cert. denied*, 456 U.S. 944 (1982).

[64] *Id.* at 378. The court said that the "critical inquiry is whether petitioner's primary purpose for engaging in its sole activity [trade or business of selling the literature] is an exempt purpose, or whether its primary purpose is the non-exempt one of operating a commercial business producing net profits for petitioner." *Id.* (quoting B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352. 356 (1978)).

[65] *Id.* at 379.

[66] *Id.* at 379 n.14.

Gospel Workers and the *P&R* case is the size of the accumulation. The *P&R* accumulation was relatively quite small. Second, the taxpayer in *P&R* had demonstrated both a need for expansion (an increased popularity in its books) and the actual carrying out of such expansion. Finally, neither the *Scripture Press* nor *Gospel Worker* courts explained why a large accumulation was indicative of a commercial purpose.[67]

3. *Significant Competition With For-Profit Corporations*

The *P&R* Tax Court held that "[a]lso significant is competition with commercial publishers, deemed to be strong evidence of the predominance of nonexempt commercial purposes.' "[68] The court felt this factor weighed against the exemption for *P&R*. According to the court, the fact that P&R sold its books to other publishing companies, as well as purchased books from other publishing companies, indicated that such competition existed. Of particular importance to the court was that at least one P&R author was very popular and could have been published by a for-profit publisher. From this objective fact the court concluded that the taxpayer must have had a nonexempt purpose.

Generally, the further the activity is removed from traditional charitable, religious or scientific functions, the greater the emphasis will be placed on whether competition exists. One of the most often cited cases on this point is *B.S.W. Group, Inc. v. Commissioner*.[69] B.S.W. was formed for the purpose of providing consulting services pertaining to rural related policy and program development. The services were priced at slightly above B.S.W.'s cost.[70] In finding that the corporation was nonexempt, the court held that the "petitioner's activity constitutes the conduct of a consulting business of the sort which is ordinarily carried on by commercial ventures organized for profit. . . ."[71] Similar to the burden

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[67] *See infra* notes 55-67 and accompanying text for discussion of Tax Court's treatment of accumulated earnings.

[68] 79 T.C. at 1085 (quoting B.S.W. Group, Inc. v. Commissioner, 70 T.C. at 358).

[69] 70 T.C. 352 (1978).

[70] The *B.S.W.* court emphasized the above-cost pricing. It quoted Revenue Ruling 72-369 to the effect:

> Providing managerial and consulting services on a regular basis for a fee is trade or business ordinarily carried on for profit. The fact that the services in this case are provided at cost and solely for exempt organizations is not sufficient to characterize this activity as charitable within the meaning of § 501(c)(3) of the Code. Furnishing the services at cost lacks the donative element necessary to establish this activity as charitable.

Id. at 356. The *B.S.W.* court contrasted Revenue Ruling 71-529 which held that an "organization providing investment management services to other exempt organizations at substantially below cost is exempt." *Id.*

[71] *Id.* at 358.

placed on taxpayers to show that the accumulation of income was for an exempt purpose, the court placed the burden on the taxpayer to show that the organization was not in competition with for-profit corporations. The *B.S.W.* court held that the "[p]etitioner has completely failed to demonstrate that its own services, or the services performed by its consultants, are not in competition with commercial businesses such as personnel agencies, consulting referral services, real estate agents, housing rental services, banks, loan companies, trash disposal firms or environmental consulting companies."[72] According to the *B.S.W.* court, "[c]ompetition with commercial firms is strong evidence of the predominance of nonexempt commercial purposes."[73]

The *B.S.W.* decision is representative of many cases involving less traditional charitable enterprises. For example, in *Federation Pharmacy Services, Inc. v. Commissioner*,[74] the Tax Court denied an exemption to a non-profit corporation that operated a pharmacy selling drugs at cost to elderly and handicapped persons. The Tax Court supported its finding of a substantial commercial purpose by noting: "[M]any profit-making organizations sell at a discount. Nor does the fact that the petitioner seeks to sell its drugs at cost alter the result; so does an old fashioned cooperative, yet it is not entitled to classification as charitable."[75]

In *American Institute for Economic Research v. United States*,[76] the Court of Claims held that an investment advisory service was not operated for an educational purpose even though it had set up a fellowship and scholarship program. The court reasoned that the products sold by the organization were of a commercial type and that the people who were making payments to the corporations were paying for a desired service, thus rendering it difficult to view the payments as "charitable contribu-

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[72] *Id.* The *B.S.W.* court held that the following factors are to be considered in determining whether or not the purpose of a non-profit corporation's trade or business is commercial or non-commercial: 1. the particular manner in which an organization's activities are conducted; 2. the commercial hue of those activities; and 3. the existence and amount of annual or accumulated profits. *Id.* at 357.

It is not sufficient to characterize this activity as charitable within the meaning of § 501(c)(3). This group does not resemble the framework which is typical of a § 501(c)(3) organization in that it neither solicited nor received voluntary contributions from the public and its fees for services were set above cost, although maybe lower than that of other firms.

[73] *Id.* at 358.

[74] 72 T.C. 687 (1979), *aff'd*, 625 F.2d 804 (8th Cir. 1980).

[75] *Id.* at 692. The dissent in *Federation* was willing to ignore the competition with for-profit corporations by noting that the taxpayer did not sell items related directly to health care and normally sold by pharmacies for profits nor did it advertise. *Id.* at 698. The dissent also noted that unlike a commercial enterprise, the taxpayer depended upon the services of volunteers to continue operating.

[76] 302 F.2d 934 (Ct. Cl. 1962).

tions"(since they were purchasing a commercial-type good).[77] The *AIE* court held:

> In order for plaintiff to obtain its "contributions," it must proffer something valuable in return. This necessity or purpose to provide such information and service as would be desired by the public places plaintiff in competition with other commercial organizations providing similar services. Plaintiff has chosen to compete in this manner and, as a consequence, plaintiff's activities acquire a commercial hue.[78]

In contrast to cases such as *B.S.W.*, *Federation* and *AIE*, the courts have allowed an exemption to what would otherwise appear to be commercial establishments where the taxpayer establishes its uniqueness. For example, in *Goldsboro Art League, Inc. v. Commissioner*,[79] the taxpayer operated two commercial art galleries, as well as carrying on other educational work. The taxpayer selected paintings for distribution at the galleries and upon their sale provided eighty percent of the proceeds to the artist and twenty percent was maintained to defray expenses. The IRS argued that since the taxpayer operated like any other commercial gallery, the evidence indicated that the sales activity was an end in itself rather than a means of accomplishing an exempt purpose. While acknowledging that the taxpayer apparently appeared to operate like any other commercial gallery, the court felt that other factors overrode the indicia of a commercial purpose. One of the most important factors, according to the court, was that there was no other art gallery in the area.[80]

In *Peoples Translation Service v. Commissioner*,[81] the taxpayer published a magazine containing translations from foreign publications. Generally, the taxpayer operated in many respects like other commercial publishers. In finding that the taxpayer was an exempt organization, however, the Tax Court focused primarily on the fact that the organization did not compete with other publishers, that it maintained a library open to the public and it translated material for scholars not otherwise available to scholars at no cost. In addition, the subscription rate for the taxpayer's magazine was below cost.[82] On this basis the Tax Court held that the

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[77] *Id.* at 938 ("It is obvious that the service offered by plaintiff is one commonly associated with a commercial enterprise.").

[78] *Id.*

[79] 75 T.C. 337 (1980).

[80] *Id.* at 344. Among the other factors considered by the court was: 1. that the members of the board of the taxpayer had various professions and were not making their incomes solely from the organization; 2. that the organization provided educational classes; 3. that the galleries had permanent collections which were not for sale; and 4. that the organization relied heavily on volunteers, although it did have some paid employees.

[81] 72 T.C. 42 (1979).

[82] On the issue of below-cost pricing, the *Peoples Translation* Court held:

> Both this Court and the Commissioner have recognized, however, that providing

organization was fulfilling an exempt purpose even though it otherwise resembled a commercial operation.

Finally, in the *Edward Orton, Jr., Ceramic Foundation v. Commissioner* case,[83] discussed *supra*, the taxpayer was in direct competition with other pyrometric cone producers. In finding that the corporation was exempt, the court focused on the amount of income which was used to provide scholarships and otherwise fund research in the pyrometric cone field.[84]

4. *Affiliation With Traditional Exempt Organization*

The Tax Court in *P&R* considered it significant that the taxpayer was "not affiliated or controlled by any particular church organization. . ."[85] According to the Tax Court "this non-denominational character 'contributes to the resemblance between its publishing activities and those of commercial, non-exempt publishers of Christian literature with whom . . . [i]t competes.' "[86]

This "affiliation" factor has been considered important in many cases. It appears to be the primary distinction between those religious publishing company cases in which an exemption was upheld and those where it was denied.

St. Germain Foundation v. Commissioner[87] was the first major case on this point. In *St. Germain*, the taxpayer's organizers had established the "I am" religion. The primary precept of this religion was the existence and relationship of God-self in each individual, and that the "mighty I am presence" is a source of all life. A primary activity of the taxpayer was the sale of religious literature to be used in the dissemination of its beliefs. However, the corporation also ran classes at which the religion's principles were taught. Unlike a strictly commercial enterprise, the religion also received substantial contributions from believers. On the basis of this close affiliation between the religion espoused by the taxpayer and

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services or publications at prices below cost is a factor to be taken into account. In B.S.W. Group, Inc. v. Commissioner, supra at 359, the Court pointed out that "it does not appear that petitioner ever plans to charge a fee less than 'cost'." In Rev. Rul. 72-369, 1972-2 C.B. 245, 246, the Commissioner stated that "Furnishing the services at cost lacks the donative element necessary to establish this activity as charitable" and distinguished the case of a similar organization on the ground that its fees were "substantially less than cost."

Id. at 50.

[83] 56 T.C. 147 (1971).

[84] *Id.* at 159.

[85] 79 T.C. at 1086.

[86] *Id.* at 1086 citing Incorporated Trustees of Gospel Worker Society v. United States, 510 F. Supp. at 379 n.16.

[87] 26 T.C. 648 (1956).

the sale of literature, the Tax Court upheld the exemption reasoning:

> The sale of religious literature and the conclaves held to propagate the precepts of the petitioner are activities closely associated with, and incidental to, the religious purposes of the petitioner. Such activities bear an intimate relationship to the proper functioning of the petitioner, and we do not believe that income received from these activities prevents the petitioner from being an organization organized and operated "exclusively" for religious purposes within the meaning of § 101(6).[88]

The type of affiliation required by *P&R*, as exemplified by *St. Germain*, is very formal. Merely espousing the use of a particular religion appears to be insufficient since P&R was "affiliated" with the Orthodox Presbyterian Church in terms of its philosophy.

The Tax Court's rejection of this informal affiliation is supported by *Fides Publishers Association v. United States*.[89] The goal of the taxpayer in *Fides* was the active participation of Catholic laymen in the affairs of the church which, until the time of the case, was completely dominated by the clergy. Fides published numerous books admittedly religious in nature. Although the organization's principal officer was on the faculty of the University of Notre Dame, the taxpayer was independent of the institution as well as the local Catholic diocese. Because Fides did not itself constitute a church, nor was it affiliated with a church, the court reasoned that it could not find the organization exempt:

> The exemption can only be denied . . . if the taxpayer is being operated for some non-exempt purpose which is substantial in nature. Such a purpose does exist. It may be described as the publication and sale of religious literature at a profit. In effect, the sole activity of Fides defines at least one purpose for which it is operated. It could not be otherwise. If it were, every publishing house would be entitled to an exemption on the ground that it furthers the education of the public.[90]

While the court accepted the taxpayer's sincerity in its belief that it was furthering its religious goals, the court considered this fact irrelevant in light of the substantial nature of Fides' trade or business.[91]

Finally, the Tax Court expressed a similar view in *Christian Manner International, Inc. v. Commissioner*,[92] in which the taxpayer was organ-

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[88] *Id.* at 658.

[89] 263 F. Supp. 924 (N.D. Ind. 1967).

[90] *Id.* at 935. The *Fides* Court relied on Scripture Press Found. v. United States, 285 F.2d 800 (Ct. Cl. 1961).

[91] 263 F. Supp. 924 (N.D. Ind. 1967). The *Fides* Court held that "[T]o deny that Fides, an independent, profit-making publisher of specialized literature, is operated for a business purpose, is to avoid reality. Having no other function, that purpose must be ascribed to it notwithstanding sincere disclaimers of any such intent." *Id.* at 936.

[92] 71 T.C. 661 (1979).

ized by a writer of Christian books. The taxpayer's books were generally sold at a profit. Christian Manner argued that an exemption was required because its purpose in publishing the books was primarily to further Christian beliefs. Noting that the case was similar to *Scripture Press Foundation* and *Fides*, the court found that the taxpayer's sole purpose was commercial.

5. *Other Indicia of Commercial Purpose*

The Tax Court found that P&R's conscious attempt to transform itself into "a more mainline commercial enterprise" showed that it no longer had a substantial exempt purpose. Among the factors listed were: "it searched out more readers; it employed paid workers; it dropped money-losing plans; it paid substantial royalties; it made formal contracts with some authors; and, of course, it expanded into a new facility from which it could continue to reap profits."[93] The Tax Court's criticism of P&R for its attempt to operate efficiently appears especially inappropriate. If a taxpayer is operating for a legitimate exempt purpose, it should not be denied the exemption merely because it is operating in such a way as to maximize its effectiveness. In fact, in many cases involving what are apparently traditional commercial enterprises, the Tax Court has upheld exemption without an analysis of the efficiency of the taxpayer's operation. For example, in the *Orton* case,[94] every indication was that the taxpayer was operating in such a way as to maximize earnings. In fact, in none of the recent cases in which the exemption has been upheld has the court found that the taxpayer was not operating efficiently in support of its holding.

III.

THE THIRD CIRCUIT'S ANALYSIS

The Third Circuit described the issue in the *P&R* case as being "at what point should successful operation of a tax exempt organization be deemed to have transformed that organization into a commercial enterprise and thereby to have forfeited its tax exemption."[95] Without being specific, the Court of Appeals first criticized as inflexible the Tax Court's reliance solely upon objective facts. It concluded that "it is doubtful that any small-scaled exempt operation could ever increase its economic activity without forfeiting its tax exempt status under such a definition of non-exempt commercial character" [*i.e.*, the accumulation of capital,

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[93] *Id.* at 1086.

[94] *See Orton v. Commissioner*, 56 T.C. 147 (1971).

[95] 84-2 U.S. Tax Cas. (CCH) ¶ 9764 at p. 85,252.

profitability and efficient operation].[96] The court then proposed the following test: "We believe that the statutory inclusion or exclusion of P&R should be considered under a two prong test: first, what is the purpose of an organization claiming tax exempt status; and, second, to whose benefit does its activity inure?"[97]

A review of the Third Circuit's test as applied to the *P&R* situation shows it to be virtually identical to that applied by the Tax Court — the only distinction being the conclusion drawn by the Court of Appeals from the same objective facts focused on by the Tax Court.

A. *Private Inurement*

The first part of the Third Circuit's analysis requires a determination of whether any part of an organization's net earnings inure to the benefit of any private shareholder or individual. The court relied upon Treasury Regulations to the effect that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.[98]

The Third Circuit"s emphasis on private inurement is not novel. In fact, virtually all the prior decisions in this area discuss the salary and expenses received by the officers. Such cases do not discuss the issue in terms of "private inurement" but whether or not the excessive salaries and expenses show that the organization had a "commercial purpose" rather than an exempt one.

For example, in *Incorporated Trustees of the Gospel Worker Society v. United States*,[99] a significant reason why the court found the organization's sale of religious literature to be non-exempt was the fact that a primary officer's salary had increased from $25,000 in 1970 to over $100,000 in 1978. In contrast, in *St. Germain Foundation v. Commissioner*,[100] and *Pulpit Resource v. Commissioner*,[101] the courts noted the reasonable salary and expenses to justify a finding of an exemption.[102]

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[96] *Id.*

[97] *Id.* at 85,252. The Third Circuit held that its two-part test was supported by the legislative history of § 501(c)(3). The court quoted Senator Bacon, the sponsor of the bill. *Id.*

[98] *Id.* at 85,252-54 (citing Treasury Regulation § 1.501(c)(3)-1(c)(2) stating that where individual officers of an organization receive excessive salaries or expenses, private inurement exists). In *P&R*, the most highly paid officer, Bryce Craig, received just over $15,000. None of the other seven employees received salaries over $12,000 and, in fact, five were paid under $6,250. The Third Circuit considered such salaries reasonable.

[99] 510 F. Supp. 374 (D.D.C. 1981), *aff'd*, 672 F.2d 894 (D.C. Cir. 1981), *cert. denied*, 456 U.S. 944 (1982).

[100] 26 T.C. 648 (1956).

[101] 70 T.C. 594 (1978).

[102] *But see* B.S.W. Group, Inc. v. Commissioner, 70 T.C. 352 (1978) and Fides Publishers Ass'n v. United States, 263 F. Supp. 924 (N.D. Ind. 1967) where the courts refused to hold

B. *Third Circuit's Purpose Test*

The court next turned to the second prong of its test: what is the taxpayer's true purpose? Although critical of the wholly objective nature of the Tax Court's purpose test, the Third Circuit failed to articulate a clear alternative. To the contrary, it appears to concede the validity of the Tax Court's approach while at the same time rejecting its conclusions.

Like the Tax Court, the Third Circuit held that the ultimate question of fact is whether the officers of P&R had a substantial non-exempt motive.[103] Nevertheless, in order to resolve this question of intent, the Court of Appeals relied upon the same evaluation of objective facts as proposed by the Tax Court:[104]

> The Tax Court properly framed the inquiry as to whether P&R's purpose was within § 501(c)(3) as follows: where non-exempt purpose is not an expressed goal, courts have focused on the manner in which the activities themselves are carried on, implicitly reasoning that an end can be inferred for the chosen means.[105]

Thus, the Third Circuit leaves the impression that while the Tax Court's approach was "inflexible," it could not develop a better method. Instead, the Circuit Court merely rejected the conclusions reached by the Tax Court based on the same objective facts.

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that the payment of little or no salary to the taxpayer's officers indicated a non-exempt purpose.

[103] 84-2 U.S. Tax Cas. (CCH) ¶9764 at 85,254. Although not particularly clear, it appears that the Third Circuit may take a more lenient view than the Tax Court as to whether an exemption is available as long as the "primary" purpose is exempt. The Circuit Court appears to say that the Supreme Court's *Better Business* "single non-exempt purpose" may be limited to the facts of that case where the taxpayer had explicitly expressed a non-exempt purpose. *Id.*

[104] *Id.* The Court of Appeals supported its use of objective facts to show subjective intent by citing Griffin v. County School Board, 377 U.S. 218 (1964). In *Griffin*, the plaintiffs challenged a Virginia County's closing of its public schools. The Supreme Court held that the County's intent was to maintain an illegally segregated school system. Unlike *P&R*, there was no viable legitimate purpose to offset the likelihood that the defendant had an inappropriate motive for its actions.

It is questionable whether *Griffin* supports the Tax Court's and Third Circuit's focus on objective facts. The *Griffin* decision is properly limited to those cases where, under the circumstances, an improper motive can be presumed. That is, as in *Griffin*, the approach is limited to those instances where an improper intent is the most likely case. Where a legitimate motive is just as likely as an illicit one, *Griffin* is inapposite. In the context of a nonprofit corporation, if it is found that the corporate officers truly believe they are acting to further a legitimate exempt purpose of objective facts which could show an alternative purpose although not inconsistent with the taxpayer's exempt purpose, the application of *Griffin* is erroneous.

[105] 84-2 U.S. Tax Cas.(CCH) ¶9764 at 85,254.

1. *P&R's Accumulation of Income*

The Court of Appeals first questioned the Tax Court's treatment of P&R's accumulation of income. According to the Third Circuit, P&R's notification to the IRS that it was accumulating funds to purchase or build an office and warehouse supported the taxpayer's contention that the accumulation was for a legitimate purpose. The Court of Appeals supported its conclusion by citing the accumulated earnings tax provisions[106] which specifically allow a corporation to accumulate earnings in order to "provide for bona fide expansion of business or replacement of a plant . . . ."[107]

The Third Circuit's rejection of the Tax Court's emphasis on the fact of accumulation was warranted. Internal Revenue Code Section 511 clearly indicates that an exempt organization can earn profits not subject to income tax where it is generated by a related trade or business. Once it is accepted that profits can be generated by an exempt organization, it necessarily follows that such an organization can accumulate that profit, especially if the purpose of the accumulation is to ultimately further the exempt purposes of the organization. Thus, a legitimate question exists as to whether accumulation of profit should be treated as an indicia of a commercial purpose at all.

If accumulation has any relevance, it is as to whether the officers are sincere in their desire to accomplish the organization's exempt purpose. For example, if an organization's purpose is to disseminate the principle of a particular religion, a large accumulation of profits which could be used to further that purpose, may indicate that the organization's officers are not sincere in their belief. However, if it is clear from other facts that the officers are in fact sincere, and there is no evidence of private inurement offsetting the evidence of the sincerity, any explanation for the accumulation as furthering an exempt purpose should suffice to dispel whatever indicia of a commercial purpose might be indicated.[108] Any other rule requires a circular determination of whether the taxpayer's reason for the accumulation shows a commercial purpose (the Service having

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[106] 26 U.S.C. § 531, *et seq.* (1982).

[107] 84-2 U.S. Tax Cas. (CCH) ¶9764 at 85,256 quoting 26 C.F.R. § 1.537-2(b)(1) (1984). The Third Circuit's reliance on the cumulative earnings tax provision is questionable. The purpose of that provision is to prevent individuals from not distributing earnings in order to avoid the taxation on the dividends. Such a provision is inapposite to the issue here, which is whether or not the accumulation shows that the taxpayer's purpose in earning profits was commercial rather than non-exempt.

[108] Arguably, if an exempt organization carrying on a trade or business has generated substantial profits it should lower the prices for its goods. *See P&R*, 79 T.C. at 1085. However, the Tax Court should not be in the position of second-guessing the decision of corporate officers who sincerely believe they are fulfilling an exempt purpose in the best manner possible.

originally argued that the accumulation itself showed a commercial purpose). Presumably, to resolve this latter issue one must look at the other indicia of commercial purpose — the same issue as the trier of fact was required to resolve originally.[109]

2. *Affiliation With Traditional Exempt Organization*

The Third Circuit also rejected the Tax Court's treatment of the fact that P&R was not formally affiliated with any church. According to the Third Circuit, the informal affiliation with OPC should have been found sufficient. The court relied on *Fides Publishers Association v. United States*,[110] in holding that "the denominational or non-denominational character of an organization has never been a controlling criterion."

The Third Circuit's reliance on *Fides* was misplaced since in *Fides* itself there was only an informal affiliation with the Catholic church (as there was between P&R and OPC) and the court found that the organization was not exempt. Nevertheless, the Third Circuit's treatment of the affiliation issue is correct since the organization seeking an exemption is doing so based upon its own activities and not that of another exempt organization.[111] The only issue should be whether the taxpayer itself is fulfilling an exempt purpose. This has been recognized by the Tax Court in numerous opinions, such as *Pulpit Resource*[112] and *Orton*,[113] where there was not even an informal affiliation with a more traditional exempt organization.

The affiliation issue should be discussed in conjunction with the competition issue. Affiliation is relevant only to the extent it lends support to a taxpayer's contention that it has an exempt purpose. In cases such as *Scripture Press*,[114] where the organization was a bona fide religion, it is easy to accept that the dissemination of the organization's material is for exempt purpose (*i.e.*, furthering the religious goals of the organization). When there is no affiliation, however, the question becomes how to distinguish between a typical commercial publisher of religious material and an organization claiming an exempt purpose. In fact, it was just on this basis that the *Fides* Court rejected the organization's claim that it was an ex-

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[109] For example, in *P&R* the Tax Court concluded that P&R's purpose behind expanding was the nonexempt one of selling religious literature at a profit. *See P&R*, 79 T.C. at 1087. The only way to resolve the dispute was to make the same determination as if the court had not discussed the accumulation issue.

[110] 263 F. Supp. 924 (N.D. Ind. 1967).

[111] *Compare* feeder organizations under 26 U.S.C. § 502.

[112] Pulpit Resource v. Commissioner, 70 T.C. 594 (1978).

[113] Orton v. Commissioner, 56 T.C. 147 (1971).

[114] Scripture Press Found. v. United States, 285 F.2d 800 (1961), *cert. denied*, 368 U.S. 985 (1962).

empt organization.[115] It is in this light that the connection to the competition issue becomes clear.

If the taxpayer can show that no commercial publisher publishes the same material as that of the exempt organization and that the material furthers the organization's exempt purpose, affiliation with another exempt organization should be unnecessary. That is, where there is no affiliation, the issue should be whether the exempt organization is filling a void left unfilled by the marketplace. If competition is present, and there is no affiliation, it would be difficult to distinguish the organization from other commercial publishers. In such cases, denial of the exemption would appear warranted absent other evidence, such as proof of the performance of substantial non-commercial activities.

3. *Other Factors*

Once the Third Circuit concluded that accumulation of profits and lack of affiliation were inappropriate objective factors for determining that P&R had a commercial motive, it reasoned that the remaining factors supported an exemption. The court apparently considered unpersuasive: (1) that P&R competed with commercial publishers; (2) that it had to pay royalties to its authors; (3) that it would not publish a book which would not sell; (4) that there was little public contribution to the organization;[116] and (5) that it did not decrease the price of its popular books so as to increase the dissemination of its belief. The Third Circuit gives little guidance as to why these factors did not support the Tax Court's conclusion.

4. *Success of P&R*

The Third Circuit's failure to analyze the other factors raised by the Tax Court probably reflects that court's belief that the Tax Court was primarily concerned with P&R's recent success. In essence, the Third Circuit held that the Tax Court was unjustly penalizing P&R for its success in fostering a growing acceptance of its religious principle. To this extent the Third Circuit's holding was primarily grounded on public policy: if individuals with minority religious or philosophical views work within the context of an exempt organization and their views begin to gain wide public support, the result should not be the loss of tax-exempt status.

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[115] 263 F. Supp. 924, 934 (N.D. Ind. 1967)(the taxpayer failed to distinguish itself from commercial publishers).

[116] It would seem that if an organization is fulfilling a charitable, religious or educational role, that there would be members of the public willing to support the organization. It is noteworthy, however, that even though P&R received little public financial support, it did have a partially volunteer staff. 79 T.C. at 1086.

As stated by the Third Circuit:

> Our concern is that organizations seeking section 501(c)(3) status may be forced to choose between expanding their audience and influence on the one hand, and maintaining their tax-exempt status on the other. If this were a stagnant society in which various ideas and creeds preserve a hold on a fixed proportion of the population, this concern would evaporate. A large religious institution with a broad base of support, such as one of the more established churches, could be the springboard for large-scale publishing houses dedicated to advancing its doctrines and be assured of qualifying for § 501(c)(3) coverage. A small denomination, such as the OPC, could then have within its penumbra only a small-scale operation run off a kitchen table. In such circumstances, any attempt by a publisher adhering to the views of small denomination to expand its scope of activities would properly raise questions relating to its continued eligibility for tax-exempt status.[117]

While such a holding may be sound policy, it provides little guidance in the more typical case.

IV.

PROPOSED TEST

The Third Circuit criticized the Tax Court on the basis that the Tax Court's test would lead to "ad hoc decisions." The Third Circuit apparently believed that a test focusing just on objective facts could cause the denial of an exemption to organizations whose purposes truly were exempt (as the court presumably felt P&R's was). Nevertheless, the Third Circuit fails to articulate any better analytical approach.

From the foregoing analysis of the precedent in this area, including the standards set forth by the Tax Court and Third Circuit in *P&R*, the following test appears appropriate for determining whether section 501(c)(3) is available to a taxpayer whose primary activity is the carrying on of a trade or business.

The first issue should be whether or not the taxpayer's organizers and officers sincerely believe that their operation of the organization is primarily for fulfilling an exempt purpose and that such a purpose is being fulfilled.[118] In this context, the private inurement test of the Third Circuit in *P&R* should be considered. While numerous court cases have held that such officers' sincerity is irrelevant to the issue of determining exempt status, those cases appear to be at odds with the express language

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[117] 84-2 U.S. Tax Cas. (CCH) ¶9764 at 85,257.

[118] For example, in the *P&R* case, the first step in the analysis would be to determine whether the organization's officers truly believed they were fulfilling a religious purpose without regard to any other objective factors. In this regard the officers' religious training and work with OPC would be relevant.

of the statute. Section 501(c)(3) is based upon the "purposes" of the organizers of an exempt corporation and not its "activities." If it is found that the members of the organization sincerely believe that they are furthering an exempt purpose, and their purpose is one of those which allows for exemption under the statute, there should be a presumption that section 501(c)(3) applies.[119]

The second part of the analysis should be to determine which of the objective factors relied upon by the Tax Court are present. The burden should be on the Internal Revenue Service to identify which objective factors it believes shows a non-exempt purpose. For example, if the Service contends that the organization competes with commercial enterprises, it must produce evidence that such competition exists.

Third, for each factor that is present, the taxpayer must produce evidence showing why that factor does not diminish its exempt purpose. The taxpayer's burden here should merely be one of production with the burden of proof remaining on the Service. For example, where there are profits, the taxpayer should be required to produce proof showing that this profit is necessary if it is going to generate income sufficient to carry out its exempt purpose. That is, it must show an inability to obtain voluntary contributions of enough size to continue its operations at the level reasonable in light of the nature of its activity and the amount of public interest. If there is a significant amount of accumulated earnings (and there is a legitimate question whether this fact should be considered at all), the taxpayer must produce evidence showing the purpose for the accumulation. For example, in the case of P&R, accumulation was necessary for the purchase of a building. In this regard, documentation of the plans (as necessary in the accumulated earnings tax context) would be relevant evidence. The taxpayer should also produce evidence showing that there is a need for the expansion (*i.e.*, that there is sufficient public interest to justify the expansion). Where the taxpayer is not affiliated (formally or informally) with a traditional exempt organization (*i.e.*, a church), the taxpayer must introduce evidence that a for-profit corporation does not fill the same role as that of the reported exempt organization. For example, if no commercial organization were willing to undertake the translation of foreign newspapers, as was the case in the *Peoples Translation* case, the lack of affiliation of the exempt organization with an educational institution would be acceptable. On the other hand, when an author writes religious tracts which are able to be sold for a profit, the lack of affiliation may be determinative of a commercial purpose. Of course, the more an

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[119] Although not clearly expressed in the Third Circuit's opinion, the court was apparently concerned that taxpayers with sincere and legitimate motives were being excluded by the Tax Court's focus just on objective facts. Such concern is implicit in the court's discussion of the difficulty in determining a corporate body's nature.

organization performs exempt functions other than those associated with the carrying on of a trade or business, the less need there should be for evidence of no alternative in the market place since the main reason for considering affiliation is to distinguish the exempt organization from a commercial enterprise performing similar services (*i.e.*, a commercial publisher of religious books).

Once the taxpayer has introduced evidence to show why each of the objective factors does not diminish its exempt purpose, the burden should be on the IRS to prove that the reasons proffered by the taxpayer were mere pretext. This is essentially what the Third Circuit held in rejecting the Tax Court's reliance upon the accumulated earnings of P&R.

Such a test best compares with the language and purpose of section 501(c)(3) while still assuring that the section will be unavailable to organizations whose ordinary goal is commercial.